Is Global Investing Worthwhile? | February 6, 2012
A Look Ahead

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When investors in LMCG's Global MultiCap strategy saw their year-end statements for 2011, they saw a comparison of our returns against the global MSCI ACWI IMI equity index as well as to the domestic S&P 500 Index. The one year difference of 10.0% in favor of the S&P 500 has created anxiety for some of our investors and representatives about global investing, even though the "since inception" performance has shown this strategy outperforming both the S&P 500 and MSCI ACWI on a gross basis. Daily headlines concerning the European Crisis haven't helped calm investors either. Shame on us for not providing better perspective, as some of our distributors are now having to answer questions about why a portion of their assets are being invested outside of the United States at all – This article is meant to redress this oversight.

The table below shows how substantially the S&P 500 Index led most other asset classes around the world in 2011:

	As of 12/31/11 (annualized)		
	1 Year	**3 Years**	**5 Years**
S&P 500	2.1%	14.1%	-0.3%
Russell 2500	-2.5%	18.4%	1.2%
MSCI Europe	-11.1%	7.9%	-5.2%
MSCI Pacific ex Japan	-12.8%	20.8%	2.7%
MSCI Japan	-14.3%	1.7%	-6.6%
MSCI Emerging Markets	-18.4%	20.1%	2.4%
MSCI ACWI IMI	-7.9%	12.8%	-1.6%
MSCI ACWI IMI ex USA	-14.3%	11.5%	-2.7%

Source: FactSet.

Last year, the S&P 500 Index returned only its dividends, as shown by the disheartening +2.1% return, but returns for the rest of the world fell over -14.3% (MSCI ACWI IMI ex USA). The –18.4% return of the MSCI Emerging Markets index includes some awful individual country performances – India fell -37.2% while China and Brazil fell -18.4% and -21.8% respectively. Some of the smaller countries fared better, but still, only a handful of returns beat that of the United States (see our article from August 13, 2010 on our web site "Small Riders May Win This Race" for more perspective on why these small countries may be extremely important in the years ahead). Your clients may justifiably be asking - why leave the confines of the United States when the world seems to be an unsafe – and unprofitable - investment?

Longer Term Return Perspective

While the S&P 500 led most country returns last year, non-US equities have posted strong relative returns in the past decade. The strong performance is linked both to accelerating growth in new economies and a successful reorganization of financial institutions following the Asian crisis of 1997-1998.

	As of 12/31/11 (annualized)
	10 Years
S&P 500	2.9%
MSCI ACWI IMI ex USA	7.0%
MSCI Emerging Markets	13.9%

Source: FactSet.

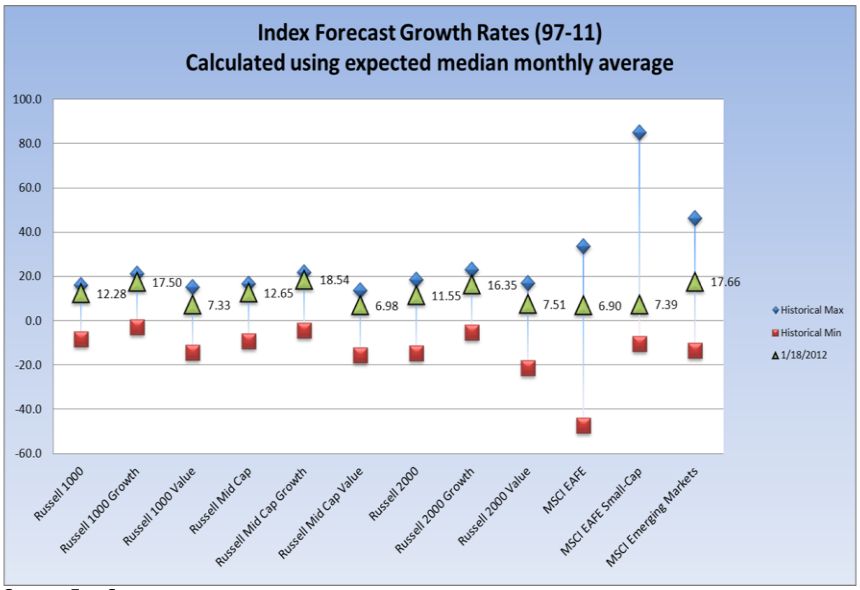
Most analysts look at historical returns as a useful reminder that international investing can boost returns particularly when the US market struggles. But viewed another way, a global equity mandate should have protected US investors from periods when their own market became excessively valued – that was the case for the United States in 2000. A global equity manager should provide that protection.

Growth and Value

Prior to the 1980s, international equities were attractive primarily for their value characteristics, a means to acquire cheap assets or commodities compared to what was available through United States public markets. The assumption was that long term growth was almost exclusively a United States phenomenon. Thanks to the dramatic spread of free enterprise and the opening of markets that followed the end of the Cold War, expectations of growth and the value placed upon those expectations have become dynamic and often highly compelling. We believe that the roles of global equity managers like us are twofold –

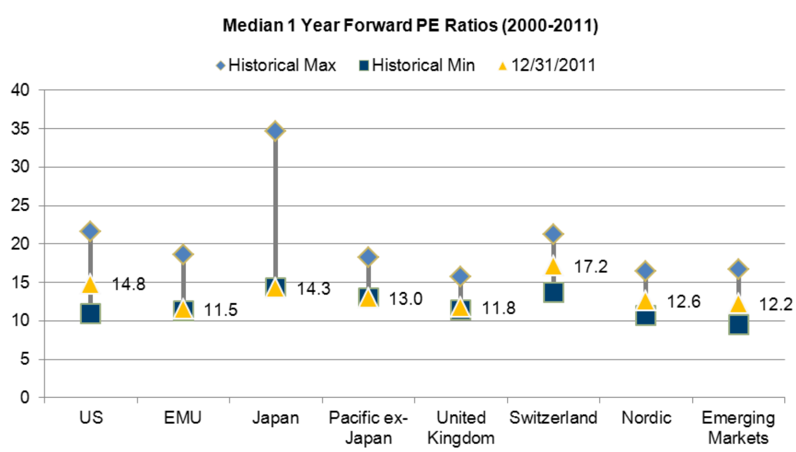
1. To identify areas where growth expectations are valued attractively, and
2. To lower asset class exposure as valuations become excessive either on an absolute or relative basis.

Many international investors rely on forecasts of GDP growth, and those forecasts tell a compelling story about growth opportunities beyond the United States. We pay more attention to the earnings expectations of the companies we buy and the valuation placed upon those expectations than we do to GDP growth. However, both methodologies paint the same picture:



Source: FactSet

We believe that the European Crisis has created unusually attractive valuations in multiple regions and asset classes – although our enthusiasm is tempered by the fact that growth forecasts are still highly uncertain. The S&P 500 Index is quite attractive from standpoints of quality and earnings visibility, but many other markets are now selling at lower valuations. Should the leaders of the European Union adopt policies that appear to offer a resolution of the Euro crisis, both earnings expectations and valuations could provide a performance tailwind for non-US equities.



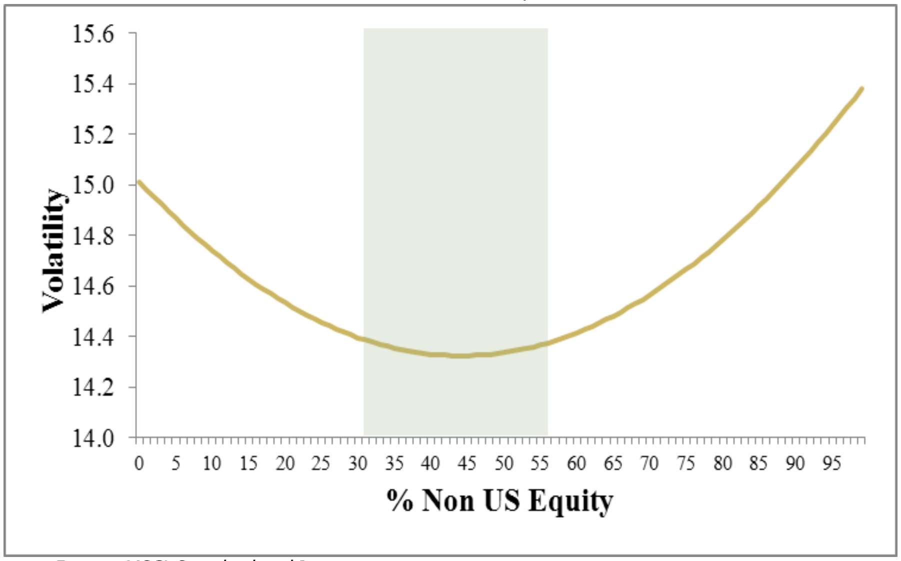
Source: FactSet

Some investors pessimistic about the current weaknesses within the US economy and of its long term competitive vulnerabilities have chosen to move to global equity mandates for defensive reasons. As you'll read when we address the Global MultiCap "home bias", we aren't in that camp. But for the past 25 years, global investing has afforded a number of terrific opportunities to capture compelling growth and value opportunities that those with more introverted US only mandates have missed. There is no question that systemic risks are higher today than at any time since the 1970s, but offshore valuations are as compelling as they have been for decades.

Risk Perspective

The mathematical representation of the advantages of international investing through diversification of risk has become stale from overuse. Worse yet, these charts promise more than international investing may deliver. The chart below summarizes a recent study showing how the standard deviation of returns falls with the addition of non-US equities to a domestic equity portfolio:

Standard Deviation Declines as Non-US equity assets are added to a US equity portfolio (returns used from 1987 to 2011)



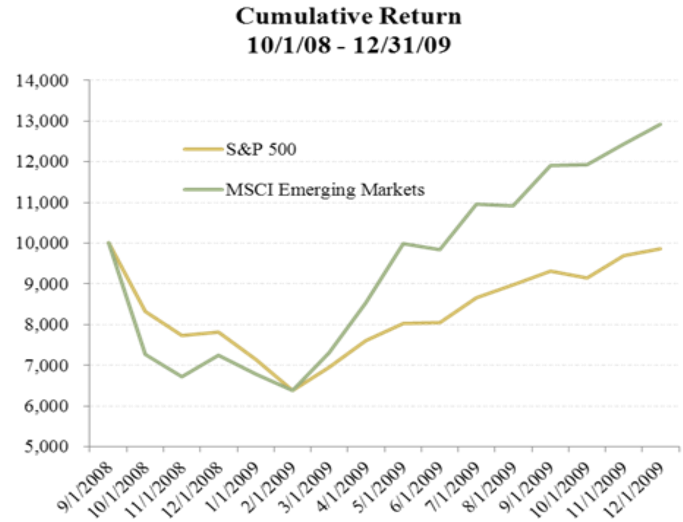
Source: Factset, MSCI, Standard and Poors

Reducing the standard deviation of portfolios by adding non-US equities did little to cushion the fall in October, 2008. Markets around the world fell dramatically, nearly simultaneously, and global diversification offered little protection:

	As of 10/31/08 1 Year
S&P 500	-36.1%
Russell 2500	-37.3%
MSCI Europe	-48.0%
MSCI Pacific ex Japan	-54.8%
MSCI Japan	-37.5%
MSCI Emerging Markets	-56.4%
MSCI ACWI IMI	-43.9%

Source: FactSet

The unique, and perhaps enduring, risk lesson followed shortly thereafter as analysts and strategist realized that the US and European financial systems were more at risk than those of Asian and emerging markets countries. Subsequent equity returns conveyed how this "risk turned upside down" translated into a recovery that began with emerging markets and were followed by the developed markets:



Source: FactSet

The lesson is this: don't invest in global equities because they reduce the standard deviation of returns compared to an all-US portfolio. Do appreciate that sound, conservative investing today requires the flexibility to move some investments overseas, and back, as circumstances change. The capital mobility of a global equity mandate creates the opportunity to produce returns in excess of the S&P 500 Index at lower risk levels.

Competitive Advantages

In 1996, Morgan Stanley Equity Research published a research piece entitled The Competitive Edge that is still impressive and relevant today. The book was one of the first attempts to objectively measure which listed companies around the world held a "sustainable competitive advantage" in each of the major industries. The understanding back then was that the forces of globalization would likely pressure or eliminate companies that did not have a sustainable competitive advantage. Even then, there was broad acceptance that for many industries the best companies were located outside of the U.S.

Following up his groundbreaking book, The Lexus and the Olive Tree, Thomas Freidman published The World Is Flat (2005), which dealt broadly with a similar theme as The Competitive Edge. One of Freidman's important conclusions for investors was that an interconnected flat world meant that there would be fewer winners in the global landscape, and those who won were likely to grow quickly to an enormous size. This week we witnessed Freidman's case in point, the (thankfully American) Facebook initial public offering. Would you ignore Facebook if it listed in the Netherlands?

Sixteen years following the publication of The Competitive Edge, few can dispute that a long term view of a company's global competitive advantage is just as important as it was in 1996. A quick look at the list of the largest public companies from 1996 shows many names that no longer exist. Some companies have gone out of business, some have been acquired or merged into domestic competitors, and some are now owned by companies in other domiciles. The result is that there is a category of company (like Unilever, Diageo, Proctor and Gamble) that source revenue from so many different markets that a country categorization is irrelevant to the investment thesis. While American investment managers used to proclaim "*I don't buy foreign stocks; I get my international diversification buying Coca-Cola*", today they would think it foolish not to compare Coke to Diageo or Asia Pacific Breweries.

In summary, domestic -only investing not only eliminates the possibility of adding value where the most competitive company is listed outside of the United States, it is harder today to differentiate what company really is a "domestic company" in ways relevant to long term security pricing.

Global MultiCap and "Home Bias"

As of 12/31/11	% U.S.	% Non-U.S.
GMC	59.0%	39.0%
MSCI AC World IMI	46.7%	53.3%

Source: FactSet

Why then, investors may ask, would we state that Global MultiCap maintains a definitive US bias to its holdings and that it likely will for some time? First of all, most investors in the strategy, like me, expect to retire in the United States which means that their liabilities for the most part will be based in US dollars. The need to push into foreign currency investments isn't as acute as it may be for the pension funds of multi-nationals or for certain families who have or plan to have multiple domiciles.

Second, as much as we may praise many foreign economies for their dramatic improvement in quality and transparency since 1989, nowhere is quite as good all-around as the United States… yet. Surely there are tax advantages elsewhere, and several countries rank ahead of the US for economic freedom. And it is painfully obvious now that there are many countries carrying a lower debt burden; but the American environment is still a haven for wealth creation - encouraging enough to be the home of the next huge success like Facebook – or to create another stunning rebirth like IBM's.

The third reason, call this the "realpolitik" reason, investors who cross borders with their money are considered "foreign investors". The rights of "foreigners" and the status of "foreign money" is an ever shifting and ever-political game around the world - including inside the US. With a nod to Tip O'Neil, all politics are local – and as a corollary, politics will tend to favor locals over foreigners in disputes. When push comes to shove, politicians will favor the ones who vote for them or are propping them up in power – and those usually aren't foreign investors (reference Malaysia currency lockup, 1997-1999 – and Venezuela and Zimbabwe today).

Finally, I return to the 1996 Morgan Stanley report The Competitive Edge which stated ***"we were surprised at the overwhelming number of U.S. companies that appear to possess a sustainable competitive advantage***". We suspect that if the work were repeated today, the numbers would be less overwhelming, but still in excess of what the capitalization weights are of the MSCI ACWI IMI today.

Summary

Both the risk and return characteristics of an equity portfolio driven by a sound global investment strategy are likely to exceed those of a U.S. only portfolio. Not only has this been the case so far in this century for passive indexes, but it is likely to be so in the future for these reasons:

- Valuations and growth expectations are compelling today for many equity opportunities outside of the United States
- Top quality multi-national companies with sustainable competitive advantages very often have their primary equity listing outside of the United States.
- Longer term, a good global equity manager should protect investors from overvaluation of their own equity markets and currency.

Of course, the most compelling and enduring reason to invest globally is for the opportunity to improve returns. We are lucky to live in a country where an abundance of opportunities and still a broad range of industries where the most competitive companies are domiciled. But 22 years after the end of the Cold War, a world of investing opportunity has opened beyond anything the Cold Warriors fighting for free enterprise and global freedom could have hoped for.

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